MINISTRY PAPER NO. 19/04

DEBT MANAGEMENT STRATEGY FY2004/05

INTRODUCTION

1. The Government's **medium-term** *Debt Management Strategy* was formulated in FY1998/99. The strategy is designed to return the public debt to sustainable levels, ensuring that the overall borrowing requirements are met at minimum cost and consistent with a prudent degree of risk. The strategy is an integral part of the management of the fiscal operations and the Government's macro-economic programme. Improvements in the debt dynamics over the medium-term will be supported by continuous reduction in interest rates, stability in the foreign exchange market and the return of the fiscal operations to surplus.

2. Despite the challenges in recent years, the Government has made significant progress in strengthening the management and operations of the debt portfolio. This has been due mainly to the proactive approach being taken in debt management which has:

- Changed the composition of the public debt portfolio;
- Positively influenced borrowing costs through the increased reliance on the market mechanism for the issuance of securities;
- Increased the transparency and predictability of debt issuance;
- Contributed to the development of the domestic capital market;
- Increased the availability and expanded the breadth of debt-related information;
- Increased market confidence through more frequent dialogue;
- Diversified the debt portfolio, thereby reducing the risk; and
- Facilitated Jamaica's continued access to the international capital markets.

3. FY2003/04 proved to be another challenging year for the implementation of the Government's medium-term *Debt Management Strategy*. The first half of the fiscal year was characterized by unusually high interest rates not seen since the mid-1990s, and extreme volatility in the foreign exchange market. The money market was tight in the second half of the fiscal year, particularly during the third quarter, and domestic investors were only prepared to invest at the shorter end of the yield curve, demanding high premiums. The developments locally were further compounded by the lowering of Jamaica's credit ratings by both Moody's Investors' Service and Standard & Poor's.

4. Despite the challenges, the Government has maintained its impeccable record of honouring all debt obligations, in accordance with the Constitution, and remains committed to achieving a sustainable debt profile, while satisfying the financing needs of the Budget at the best terms available.

5. External developments during the first half of the fiscal year also had a negative impact on Government's fund-raising efforts and the achievement of the debt strategy objectives for FY2003/04. The credit rating agencies reviewed Jamaica's economic

performance and revised the ratings. In May 2003, Moody's Investors Service lowered Jamaica's long-term foreign currency credit rating from "Ba3" to "B1" and the local currency long-term credit rating from "Baa3" to "Ba2", while maintaining its "Stable" outlook. This was followed in July 2003 by Standard and Poor's lowering its long-term foreign currency credit rating from "B+" to "B" and maintaining its "Stable" outlook. These developments, coupled with macroeconomic developments locally, affected the trading levels of the Government's eurobonds with some prices falling to low levels.

6. However, market conditions improved in the second half of the year when domestic interest rates started to trend downwards. This, combined with improvements in the fiscal operations, resulted in positive market sentiments from domestic and international investors. Externally, this was evidenced by improved trading levels of the Government's eurobonds and investors demonstrated willingness to invest in Jamaica. Despite a lowering of Jamaica's local currency credit rating from "B+" to "B" and a revision of the country's long-term rating outlook from "Stable" to "Negative" by Standard and Poor's in February 2004, the Government successfully issued €200M 5-year bonds in February 2004, in a deal that was upsized from €100M due to overwhelming demand.

Review of FY2003/04

7. At the end of March 2004, total public sector debt stood at $693.9 billion or 142.5% of GDP. This represented an increase of 15.4% over the stock of $601.2 billion or 143.9% of GDP recorded at the end of March 2003. Although the stock of debt increased by 15.4%, the rate of growth was slower than the 21.0% increase recorded for FY2002/03 over FY2001/02.

8. The stock of public and publicly guaranteed external debt stood at $276.3 billion (US$4,529.0 million) or 56.7% of GDP. This represented an increase of 17.5% compared with the stock at the end of March 2003, which was less than the 19.4% growth recorded in FY2002/03. In US$ terms, the external debt rose by 8.3% from US$4,180.0 million at the end of March 2003. The increase primarily reflected:

- The issuance of bonds in the regional and international capital markets which exceeded gross external amortization for the fiscal year;
- The adverse movements in the Euro/US$ and J$/US$ exchange rates; and
- The increase in Government guarantees mainly to facilitate certain infrastructure development projects.

9. Central Government domestic debt totaled $417.6 billion or 85.8% of GDP, an increase of 14.0% relative to the $366.2 billion stock at the end of March 2003. The rate of growth of the domestic debt in FY2003/04 was slower than the 22.0% recorded for FY2002/03. The main factors accounting for the increase were:

- The financing of a higher-than-programmed fiscal deficit during the first nine months of the fiscal year;
- The delay in accessing the international capital markets until the last quarter of the fiscal year;

- The issuance of securities in lieu of accrued interest on BOJ/FINSAC Local Registered Stocks (LRS);
- The assumption of contingent obligations on behalf of public sector entities such as the Jamaica Urban Transit Company Limited and the Metropolitan Management Transport Holdings Limited for the road rehabilitation programme;
- The sharp depreciation in the J$ vis-à-vis the US$ and the increased share of the foreign currency component of the domestic debt; and
- The issuance of debt instruments to cover the Bank of Jamaica losses.

10. In keeping with the medium-term strategy, in FY2003/04 the *Debt Management Strategy* sought to:

- Maintain a prudent debt structure;
- Use market mechanisms for domestic debt issuance;
- Promote and build a liquid and efficient market for government securities;
- Increase the transparency and predictability of primary market debt issuance;
- Finance the fiscal deficit and debt redemptions; and
- Access the external markets for funds to the extent of gross external amortization.

11. The Government achieved measured success in the execution of its *Debt Management Strategy* objectives in FY2003/04. The achievement of these objectives was constrained by the volatility in the foreign exchange market, the market's preference for shorter-term instruments in the face of high interest rates and the uncertainty surrounding macroeconomic prospects.

Maintaining a Prudent Debt Structure

Increasing the Share of Fixed-Rate Debt

12. Although the share of domestic fixed-rate debt continued to increase, from 43.2% in FY2001/02, 48.4% in FY2002/03 to 58.2% in FY 2003/04, the cost of the new fixed-rate debt issued in FY2003/04 was higher than projected due to the high interest rates that prevailed. The impact was reduced however, by issuing the higher-priced debt with shorter maturities in order to minimize the medium-term costs.

Extending the Maturity Profile

13. Market conditions during FY2003/04, as described in Paragraph 3. of this Ministry Paper, were not conducive to extending the maturity profile of the debt. In order to meet the financing requirements of the Budget under the unfavourable market conditions and in light of the need to ensure prudent debt management, the Government opted to issue more shorter-term debt than envisaged.

14. Of total new domestic debt issued in FY2003/04, 94.4% had maturities of up to 5 years compared with 45.1% at the end of FY2002/03. Only 4.2% of the new domestic debt

was issued with maturities of 10 years and over, compared with 37.6% in FY2002/03 and 17.5% in FY2001/02.

15. Of the total domestic debt outstanding at the end of FY2003/04, 73.1% had maturities of up to 5 years compared with 63.9% at the end of FY2002/03 and 17.5% at the end of FY2001/02. Maturities of 10-years and over accounted for 12.8% of the outstanding domestic stock, down from 16.9% at the end of FY2002/03.

16. External loans contracted in FY2003/04 were mainly long-term debt. The Government extended the maturity profile of its Euro yield curve with the successful placement of a 5-year €200 million bond issue. Of the total external debt outstanding at the end of March 2004, 70.0% matures over the medium- to long-term. The distribution of the external debt remains highly favourable with 24.5% maturing in 1-5 years, 26.6% in 5-10 years and 43.4 % maturing in over 10 years.

Minimizing Currency Exposure

17. At the end of FY2003/04, US$-Indexed Bonds totaled $51.5 billion (US$841.5 million equivalent) or 12.3% of the domestic debt portfolio. This compared with $42.3 billion (US$752.5 million equivalent) or 11.6% at the end of FY2002/03. The stock of US$-denominated bonds in the domestic debt portfolio stood at $45.3 billion (US$742.8 million) or 10.9% of the domestic debt portfolio at the end of March 2004. This compared with $30.6 billion (US$543.8 million) or 8.4% of the domestic debt stock at the end of March 2003.

18. The increase in the foreign currency component of the domestic portfolio reflected issuance to support the central bank's effort to stabilize the foreign exchange market, delays in accessing the external markets until the last quarter of the fiscal year and the illiquid nature of the J$ market.

Diversification of the Debt Portfolio

19. During FY2003/04, the Government continued its effort to diversify the portfolio. On the domestic side, a variable rate investment bond was introduced in July 2003. The instrument, which was well received in the market, accounts for 4.3% of the domestic debt outstanding. The Government maintained the menu of instruments already used in the portfolio. A combination of LRS, Investment Debentures, US$-Indexed Bonds and loans satisfied the needs of both institutional and retail investors.

20. On the external side, the Government maintained its policy of approaching the international capital markets for funding to the extent of gross external amortization. In October 2003, the Government issued a 5-year, US$50 million bond at a fixed rate of 9.0%, to the regional market, thus widening its investor base. In March 2004, the Government also issued another US$50 million bond in the regional market. This 4-year bond has a coupon of 9.5% and matures in 2008.

21. In February 2004, Jamaica successfully issued €200 million bonds in the European markets. Due to overwhelming demand, the Government was able to double the original size of the issue from €100 million. The bonds mature in 5 years and have a coupon of 10.5%. This is Jamaica's largest and longest dated euro-denominated issue and was an exceptional achievement for Jamaica in that market given the developments earlier in the fiscal year. The bonds have been trading at premium levels and the transaction was highlighted in the *Euromoney* magazine in February as the deal of the month.

Use of the Market Mechanism for Domestic Debt Issuance

22. A stable environment is critical to the efficient and effective functioning of market mechanisms such as auctions. The response of market players to the volatility experienced in FY2003/04, created an environment that was not conducive to the sale of instruments through the auction mechanism. Of the debt raised for budgetary financing in FY2003/04, $7.5 billion or 6.0% was raised through the auction mechanism, $91.9 billion or 74.0% through fixed-priced market instruments, while $26.9 billion or 20.0% was raised through private placements. This compared with $16.9 billion or 14.8% raised through the auction mechanism, $46.7 billion or 40.9% through fixed-priced market instruments, and $50.6 billion or 44.3% raised through private placements in FY2002/03.

Increased Transparency

23. An important objective of the debt strategy in FY 2003/04 was increased transparency in the execution of the policies. The Government continued to publish comprehensive domestic and external debt data on the Ministry of Finance and Planning's website on a monthly basis. Information on the Government's debt operations is publicly disclosed by means of monthly schedule of upcoming issues. This is complemented by advanced notices of upcoming issues. Information on Government's debt, its strategy, operations and relevant investor information are available on the Ministry's website.

24. During FY2003/04, the Government engaged the domestic market players in dialogue through various media. These included press conferences and investors' fora. There were also formal consultation and discussions between the public and private sectors in an effort to explore options for reducing interest costs. In addition, the Government maintained dialogue with the international financial community through meetings, investor presentations and conference calls, as well as non-deal roadshows.

Developing the Domestic Securities Market

25. The Government is a part of a public-private sector consultative group relating to the development of a system for the immobilization of fixed income securities. Discussions are far advanced regarding the development of the system.

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26. In keeping with international best practices, debt management in FY2004/05 will continue to be guided by the fundamental objective of the Government's **medium-term** *Debt Management Strategy* of lowering the cost of borrowing, subject to the containment of risks within acceptable levels. Increased emphasis has been placed on minimizing risk. Risk management has been an important tool in debt management and given the debt dynamics will form a critical aspect of the funding policy in FY2004/05.

27. In keeping with the medium-term objectives of the *Debt Management Strategy* set out in Paragraph 10. of this Ministry Paper, the *Strategy* in FY2004/05 will therefore seek to:

- Maintain a mix of fixed-rate and floating-rate debt to further diversify and minimize interest-rate risk;
- Extend and smooth the maturity profile of the debt to better manage refinancing risk; and
- Continue to increase the transparency and predictability of debt issuance.

Maintaining a Prudent Debt Structure

28. By its nature, debt management gives rise to a number of financial risks including interest rate, refinancing and exchange rate risks.

Maintain an Appropriate Mix of Fixed-rate and Floating-rate Debt to Further Diversify and Minimize Interest-rate Risk

29. The exposure of the debt portfolio to interest rate risk, i.e., the risk of higher interest costs as a result of increases in interest rates, is mainly a consequence of the size of the variable rate portion of the debt. In order to diversify the interest rate risk on the domestic debt portfolio, the Government will continue to issue a mix of fixed-rate and variable-rate instruments. The planned mix over the course of the fiscal year targets a 60% fixed-rate component and a 40% variable-rate component of the domestic debt. Meeting these targets would achieve the Government's medium-term fixed rate target of 60% of the domestic debt portfolio, in keeping with internationally accepted standards.

Extending and Smoothing the Maturity Profile to Better Manage Refinancing Risks

30. To manage the risk associated with refinancing, i.e., having to reissue large maturing portions of its debt in unfavourable market conditions such as high interest rates and/or tight liquidity, the GOJ will continue its efforts to lengthen the maturity profile of the debt. In order to reduce the exposure, the GOJ will further limit the concentration of debt maturities in the near-term and spread the maturities over the medium-term.

31. While meeting the funding requirements, the Government will strive to better smooth the domestic amortization profile in order to avoid placing pressure on the domestic capital market. Smoothing of the distribution of the maturities of the domestic debt will involve a

limited programme of exchange offers where the Government offers investors the opportunity to exchange securities nearing maturity (of up to one year) for new securities with longer maturities.

Minimizing Exchange Rate Risk

32. In the context of a flexible exchange rate system, with 100% of the external debt and 23.2% of the domestic debt denominated in or linked to foreign currencies, the public debt portfolio is subject to exchange rate risk.

33. For most of the last decade, Jamaica has been making net repayment of external debt. Government's external borrowing policy of approaching the international capital markets for funding to the extent of gross external amortization will ensure maintenance of the external debt indicators at favourable levels.

34. The Government is cognizant of the extent of the foreign currency exposure of the domestic debt and will take steps to reduce such exposure to internationally acceptable standards. Except under extraordinary circumstances, the Government will continue to restrict the use of U$-Denominated and U$-Indexed instruments in the domestic market in order to reduce the exposure of the domestic debt portfolio over the medium-term.

Increase Transparency and Predictability

35. The Government remains committed to transparency and predictability. These guiding principles have helped to reduce borrowing costs, strengthen Government's credibility and enable market participants to plan their investment strategies.

36. The Government will continue to offer new securities in the domestic market through the market-based mechanism – the auctions, through offers of fixed priced instruments as well as private placements. Within the context of a stable market environment, the auction mechanism will be the primary vehicle for domestic debt issues. This will encourage competitive bidding and will help the Government to lower the cost of funds.

37. Although complete predictability is not practical, the Government must however remain flexible in order to meet changes in its financing requirements and to circumvent unfavourable market conditions. The Government, therefore reserves the right, in exceptional circumstances, to cancel previously announced auctions and to raise funds through private placements. Where debt is raised through private placements, the Government will continue to invite proposals from a wide cross section of financial institutions in order to ensure transparency and competitive pricing.

38. Transparency in the Government's debt operations and borrowing programme will continue to be enhanced by:

- Monthly publications of comprehensive external and domestic debt data;
- Advanced notices of upcoming debt issues;

- Quarterly announcements of Government's borrowing requirements;
- Monthly schedules of market issues; and
- Timely publication of the results of market issues.

39. These, along with the Government's *Debt Management Strategy* and relevant investor information, will continue to be made available in the print media and/or electronically on the Ministry's website (www.mof.gov.jm/dmu). This is consistent with the high level of importance the Government places on the dissemination of accurate and timely data to the domestic market and the international financial community.

Calendar of Announcements

40. At the beginning of each quarter, the Ministry of Finance and Planning will make available to the market, gross financing requirements for the ensuing quarter. Monthly schedules of market issues will be announced by the end of the preceding month. The schedule will initially indicate the timing and type of instruments to be placed in the market. Details of the terms and conditions of the instruments will be provided to the market at least four business days prior to the tender dates.

41. In FY2001/02, the Government took a strategic decision to file a Schedule B Registration Statement with the United States Securities and Exchange Commission (SEC). This places Jamaica in a position to issue securities in the international capital markets at very short notice, thereby taking advantage of favourable market conditions.

42. As part of the filing requirement of the Schedule B/Shelf Registration process, and in keeping with the then medium-term profile of the external debt, the Government placed US$700 million on the "Shelf" with the SEC. Of this amount, US$300 million has been "drawn down" through US$-denominated eurobond issues in June 2002. In FY2004/05, the Government will seek to increase the amount under the Shelf to reflect Government's medium-term external borrowing programme. This will ensure that the Government is in a position to access the markets in a timely manner and raise funds at acceptable costs.

Market Consultation

43. During FY2003/04, the Government engaged investors and market players in constant dialogue keeping them updated on macroeconomic developments. In FY2004/05, the Government will continue this market-oriented approach to actively engage the local and international investment communities in dialogue. The formal consultative process already in existence - those organized by the financial community and those by the Government, as well as ad hoc contacts with market participants, will be further complemented in FY2004/05 by the holding of regular investors' conference calls. These will commence with the post-Budget conference call in April, followed by quarterly updates in August, November and February, after publication of the quarterly macroeconomic results. Meetings will be held with major domestic institutional investors at least twice for the year, to ensure that the views of the market players are taken into account in the development of policy and strategy. In addition,

at least once per year, the Government will meet with major institutional investors in Europe and North America.

Diversification of the Debt Portfolio

44. The broadening of the investor base for Government securities is one way of achieving the objective of borrowing at the lowest possible costs while minimizing risks. On the domestic side, in order to satisfy the needs of institutional and retail investors, the Government will continue to issue a range of instruments – LRS, Investment Debentures, Variable Rate Bonds and loans – that are repaid at maturity as well as amortized across the yield curve. On the external side, the Government will seek to further broaden and deepen its institutional retail investor base by geographic distribution.

45. International developments have played a greater role in Government's financing policy in recent years. The pricing of instruments locally, regionally and internationally is made on the basis of "international comparisons" with the trading levels of the Government's eurobonds, as well as with the trading levels of the bonds of comparable credits.

46. In seeking to access the international capital markets in FY2004/05, the Government will maintain the practice of requesting proposals from a number of international investment houses to arrange bond issues. Such a transparent process will continue to ensure that Jamaica raises funds internationally at the best terms available. In addition, the policy will ensure maintenance of Jamaica's favourable external debt ratios.

Statutory Basis for Borrowing

47. The Loan Act 1964, and its subsequent amendments, is the Government's primary borrowing authority. The Act empowers the Minister of Finance and Planning to raise loans on behalf of the Government.

48. In February 2004, Parliament approved the increase in the loan ceiling under the Loan Act from $400 billion to $650 billion. The increase was necessary to facilitate Government's medium-term borrowing programme and to allow for the assumption of contingent liabilities relating to a number of public sector entities. The ceiling will be reviewed on an annual basis, starting in FY2005/06.

49. In FY2004/05, the Government will undertake a review of the legal and regulatory framework relating to debt management. This will ensure that the relevant laws are consistent with current best practices and in keeping with technological advances and the sophistication of the capital markets.

Government Borrowing Requirement FY2004/05 and Medium-Term Targets

50. The Government's borrowing needs are determined by Central Government's fiscal deficit plus its maturing debt. Gross borrowing for FY2004/05 is projected at $152.4 billion. Of this amount, $121.7 billion is projected to be sourced from the domestic market through

the issuance of various instruments via market issues and private placements. The remaining $30.7 billion is projected to be raised from external sources.

51. Consequent on the Government's policy of approaching the international capital markets for funding to the extent of gross external amortization, over the course of FY2004/05, the Government will seek to raise U$450 million in the regional and international capital markets.

52. Debt management will make a significant difference in improving the fiscal profile. With the fiscal operations projected to be in balance by FY2005/06 and surplus thereafter, supported by the already improving macro-economic environment, the level of public borrowing will decline over the medium-term. The funding programme for FY2004/05 and the medium-term will result in a further reduction of the debt stock and the Debt to GDP ratio. Commensurate with the lowering of the debt ratios and hence declines in the level of risk, expectations are for interest rates and interest costs to fall even further.

53. The Government has and will continue to service its debt obligations in accordance with Section 116 of the Constitution which stipulates that all loans, external and domestic, represent a statutory charge on the revenues and assets of the country.

Omar Davies, MP
Minister of Finance and Planning
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